

Statement to the Advisory Committee on the Auditing Profession to the U.S.
Department of the Treasury
(Revised June 5, 2008)

John H. Biggs - Statement
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Chairman Levitt and Nicolaisen and Members of the Advisory Committee:

I appreciate very much the opportunity to present my views on matters affecting the future and effectiveness of the Auditing profession.

I would like to make my comments from the point of view of audit committees rather than from any other public policy point of view. I am currently chairman of the Boeing Audit Committee and was a member of the JPMorganChase Audit Committee until very recently. I have also been on the audit committees of several other public corporations and continue to serve as chairman or a member of the audit committee of a number of non-profit organizations, including the National Bureau of Economic Research and Council of World Affairs. I have also had personal experience as a member of the Public Oversight Board, the private sector organization that attempted to oversee auditing in the United States. The Public Oversight Board went out of existence after the passage of Sarbanes-Oxley creating the PCAOB.

I have also served terms on the Boards of Trustees who oversee and finance the FASB and the IASC.

During my years at TIAA-CREF, I frequently testified on audit issues, particularly before the Senate Finance Committee chaired by Senator Sarbanes.

These are my personal observations and are not those of the Boeing Audit Committee or the Boeing management or of any of the organizations with which I am or have been associated.

The primary purpose of my statement is to urge the auditing firms to prepare their own audited financial reports. I see this progressive step as being especially helpful to audit committees.

As is well known to you, the role of audit committees has been greatly expanded by the New York Stock Exchange listing rules and by the statutory provisions of Sarbanes-Oxley. From my personal experience, I believe that audit committees have taken this responsibility very seriously, and are devoting

significantly more time overseeing the financial reporting of American public companies.

But also most audit committee members are concerned about the increased liability they may have as board members of public companies. I have been designated in the past as the “financial expert” on several public company committees. Several shrewd observers of the corporate world, including my personal attorney, have warned me that this is a dangerous position.

It is ironic that the firms that audit all U.S. public companies do not prepare their own public audited financial reports. There is a long standing federal securities interest in having companies make open their books to investors, regulators and the public. Yet, strangely, the professional businesses that assure that openness, do not see an obligation to open their own financial records to the public, or the audit committee or even the PCAOB or your Committee.

I understand from comments made to you that it would take them several years to prepare such statements. If so then it appears that they do not make them available to their own partners.

A worthwhile progressive step that the Treasury Commission or Public Auditing could instigate would be to find a way to require or encourage, or facilitate the preparation and public issuance of such statements. Perhaps this requirement would be added to the long list of information that auditors are required to give Audit Committees, under the New York Stock Exchange listing requirements.

In particular, such financial reports would be extremely useful to audit committees as they make decisions about auditor selection or continuation.

I can assure you during the last ten years since the adoption of the strengthened NYSE listing rules and the passage of Sarbanes-Oxley, members of audit committees have changed the whole concept that we have of our role. (In most cases we are even paid more money for taking on this role than those who serve on other committees.) We spend a great deal of our time reviewing the relationship with our public auditing firm particularly when any changes are made in our arrangements.

I have not had the experience with a change of audit firms in the public companies on which I have served as a director. However, we did change auditing firms on a roughly seven year cycle when I was Chairman of the Board and CEO of TIAA-CREF. At those times we thoroughly vetted all the information we could glean from the competing firms. But the financial affairs of the firms were a “black box”, with the conflicting statements: “don’t worry we are well capitalized” but “we have large uninsurable professional liability risks.”

However, on all the Audit Committees I have served, we have had to deal with the selection of a new lead client auditor given the five year rotation requirement under Sarbanes-Oxley. In each of those cases, we have made extensive inquiries about auditor availability and the inner workings of the audit firms in terms of personnel assignments.

We, as audit committees, are required by the New York Stock Exchange Listed Company Manual to:

“(a)t least annually, obtain and review a report by the independent auditor describing: the firm’s internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues;

and (to assess the auditor’s independence) all relationships between the independent auditor and the company.”¹

This is a long and difficult list, yet nowhere is there any financial information required to let us get our teeth into the financial questions that might lead to real enlightenment on the listed “must do’s.” For example, are the margins on the auditing business sufficient for reinvesting in quality audits? Is doing quality audits the firm’s primary business activity? What resources does this firm have for potential litigation? What are the outstanding “material” claims made against your firm? (The latter is required of all public companies, why not the mammoth auditing firms that grew out of the consolidation of the 80’s and 90’s.)

Michael Cook, the distinguished former Chairman of Deloitte and Touche, has, in his retirement, served as the Chairman and/or member of numerous audit committees. He has urged the PCAOB to share information with Chairs of Audit Committees. He observed that through their inspections there was much information available to the PCAOB staff that could be extremely helpful to audit committees. Since that time one of the Board Members has been responsive with a carefully worded but useful essay for audit committees². But nothing on financial reports.

I understand that the Treasury Committee on the Auditing Profession is considering various ideas about providing better public information about the firms which, consequently, would be very helpful for audit committees.

¹Section 303A.07(c)(iii)(A) of the New York Stock Exchange Listed Company Manual.

² Daniel L. Goelzer in The Review of Securities and Commodities Regulation, Vol 41 No. 6, March 19, 2008

I would urge a focus on such transparency. With our greatly increased responsibilities and consequent risks as audit committee members, we rely heavily on the quality and strength of the audit firm we select to probe into all aspects of the company financial reporting. We need to know more about the firms we select and the risks of doing business with them. I do not believe we can delegate that responsibility to the PCAOB, especially since they are limited by the terms of the Sarbanes-Oxley Statute.

A simple first step would be to require each firm doing public audits to prepare a public financial statement, audited by a peer institution.

This is not a new idea dreamed up currently. There were speculations in a Congressional Staff Study, "The Accounting Establishment" published March 31, 1977 suggesting that "there is little data available on the profitability of the accounting firms" but the report believed they are "very lucrative enterprises."

During the 1970's, Arthur Andersen, under a progressive leadership, broke ranks in a public gesture and published financial reports for several year. They were not followed by other firms.

The Financial Executive International Committee on Corporate Reporting recommended audited financial reports as recently as last year.

It is well known that the United Kingdom's largest audit firms now publish annual audited financial reports. I have read two and they seem to me quite valuable (both audited by Grant Thornton). There is a significant paragraph in KPMG's Report that makes many of the points of my testimony:

"Transparency in financial reporting

Transparency underpins the group's commitment to quality and integrity and is vital to the wider confidence in financial reporting and global capital markets. KPMG in the UK has produced audited financial statements since 1995. The group reviews compliance with the recommendations of the revised Combined Code and related guidance. The group has complied with the voluntary disclosures of the Co-ordinating Group on Audit and Accounting Issues and has also met the future reporting requirement outlined in Article 40 of the European Union's 8th Company Law Directive, through the disclosures given in this statement and other disclosures which may be found as follows:

- Revenue by function, page 58
- Revenue split by audit and non-audit services, page 9.
- Public interest entities audited by the group, website www.kpmg.co.uk.
- Legal structure, page 46"

In the UK, Deloitte and Touche management's comments, there is the following question and answer providing the kind of useful information we should have as regulators, audit committees and the general public.

"Some questions are asked about the transparency of the audit business in firms. What is your response?"

The audited financial statements in this report include significant information on each of our business divisions. Key data regarding our audited practices includes:

- 36% of our total firms' revenue was earned from clients for whom we are auditors and within this 20% of total firm revenue related to audit fees.
- our audit division provides a range of risk advisory and consulting services and due diligence work for clients drawn from across the firm. Revenue in the audit division grew by 14.4% compared with 15.6% for the firm overall.
- The operating margin in the Audit division was 26.2% compared with 30.9% for the firm overall"

In contract, no financial reports are prepared by American firms, even for the PCAOB.

Examples of information useful to audit committees that would be provided by an annual report would include:

1. Is the Auditor well capitalized
2. What are the litigation risks and how are they protected by capital, insurance, or other means. (I note that public companies give a comprehensive analysis of litigation risk and general provision for that risk – not specific details that the plaintiff's bar could use.)
3. Does the firm invest in improving its audit capability – in terms of infrastructure, review, discipline and even controls.
4. What are the relative size of revenues and profits from non-audit practices – e.g. tax work, consulting, compensation advice, pension education work, etc.
5. All public companies have to disclose details of compensation. Why not the audit firms?

Obviously an audited financial statement of the auditing firms that was comparable to what every public corporation is required to produce would be quite valuable.

All of us in public corporations have the litigation risk that in exposing information on our legal liabilities and aggregate reserves for those liabilities may be useful to the plaintiff's bar. Nevertheless the SEC rules on reporting give us an adequate way to protect against providing specific information on specific cases.

Accordingly, in spite of the concerns of lawyers defending the major audit firms, I do not think the disclosures required in an audited financial statement would increase risks any more than they do for any public company.

As a director of JPMorganChase we were confronted with enormous potential liabilities and resulting enormous settlements that were not increased, in my opinion, due to the information provided in our audited financial statement. The fact is that juries look at any very large American business with suspicion and, given the unlimited liabilities some judges propose, there is an absolute necessity to settle with sums frequently in the billions of dollars. Such settlements could easily put an audit firm out of business. Audit committees need credible information about those risks.

Perhaps the major fear we have as an audit committee working with a firm is that at a critical period of time there may be a judgment settled against the firm that makes it impossible for them to continue an audit.

In summary, I make these basic points.

First, the New York Stock Exchange and Sarbanes-Oxley have given audit committees substantial powers, obligations and risks.

Secondly, the substantial franchise value of "the auditing profession" has been enormously enhanced by the additional compulsory requirements on public companies under Sarbanes-Oxley.

Thirdly, in spite of imposing statutory inspection of the firms by the PCAOB, there are no means for audit committees or the PCAOB or their Committee to look into the "black box" of audit firms' finances.

It is time to open up the black box.